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Good Faith in the World of Delaware Corporate Litigation: A Strategic Perspective on Recent Developments in Fiduciary Duty Law

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Abstract

The Delaware Chancery's new-found willingness to hold corporate directors accountable for breaching the duty of good faith has provoked widespread attention in both the business and legal communities. Legal practitioners and scholars recognize the novelty of Delaware's recent good faith jurisprudence, as well as its potential to expose directors to gigantic personal damage awards, and in fact have published numerous articles that seek to delimit the boundaries of good faith conduct. But until now, most discussions of good faith as a fiduciary duty have approached the subject as an abstract measure of conduct, showing little regard for how a complaint alleging bad faith would fare in an actual Delaware case.

This article adopts a unique approach to good faith by viewing the subject from a litigation-based perspective. With an eye toward the practical effects of fiduciary duty jurisprudence, the paper follows the path of a shareholder lawsuit from injury to judgment, noting where good faith has combined with other state and federal developments to change the fortunes of plaintiff shareholders and defendant directors. I conclude that recent good faith jurisprudence has all but eliminated the possibility of dismissing many fiduciary duty suits on the pleadings, and has substantially reduced a defendant's chances of prevailing at trial.

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Good Faith in the World of Delaware Corporate Litigation

A Strategic Perspective on Recent
Developments in Fiduciary Duty Law

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INTRODUCTION

Delaware corporate law, and American corporate law by extension,¹ has long been shaped by “the most scrupulous...duty” of officers and directors to “affirmatively...protect the interests of the corporation” and “to refrain from doing anything that would work injury to” it.² Traditionally, this duty has been distilled by courts into the twin fiduciary obligations of care and loyalty.³ The duty of care compels directors “to act on an informed basis” when exercising their power to manage the corporation’s affairs.⁴ In turn, the duty of loyalty demands “that the best interest of the corporation and its shareholders take[] precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally.”⁵

Although the Supreme Court of Delaware has described both duties as “equal and independent,”⁶ the duty of care has occupied a back seat in Delaware shareholder derivative lawsuits since the legislature allowed corporations to exculpate their directors from liability for most fiduciary duty violations that do not involve disloyalty or bad faith.⁷ Until recently, Section 102(b)(7) and other aspects of Delaware corporate law effectively shielded all but the most obviously culpable managers and directors from liability or trial.⁸

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¹ Delaware has long dominated the field of corporate law in the United States by virtue of its near monopoly on out-of-state incorporations. Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. CORP. L. 625, 632 (2004); *see also* Hillary A. Sale, *Delaware’s Good Faith*, 89 CORNELL L. REV. 456, 457 (2004) (dubbing Delaware “the mother of all corporate law”).

² *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939).

³ *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 367 (Del. 1993) (describing care and loyalty as the “traditional hallmarks of a fiduciary who endeavors to act in the service of a corporation and its stockholders”).

⁴ *Id.* at 367.

⁵ *Id.* at 361.

⁶ *Id.*

⁷ *See* DEL. CODE ANN. tit. 8, §102(b)(7) (2001) (available in full in Appendix); *see also* Sale, *supra* note 1, at 462 (implying that the duty of care is effectively unenforceable in Delaware and noting that “care-based cases are in the minority of derivative and class action cases....”).

⁸ Jones, *supra*, note 1, at 646-51.

But in the years since Enron and other corporate scandals directed the nation's attention to corporate governance issues, Delaware courts have seemingly become more receptive to the claims of shareholder plaintiffs. Although the courts have generally refrained from expressly overruling prior cases, many commentators believe that the protective scope of Section 102(b)(7) has been sharply diminished by good faith, a nebulous concept lying somewhere between grossly negligent lack of care and intentional, self-interested disloyalty.

By way of background, the paper begins with a brief history of the duty of care and its de facto marginalization by Section 102(b)(7). It then traces the slow development of good faith as an independent fiduciary obligation, culminating in the much-hyped denial of the defendants' motion to dismiss in the Disney litigation.⁹ Since that decision, academic commentators have spilled gallons of ink trying to decipher the exact contours of good faith, either distinguishing or equating it with care or loyalty. The paper will briefly examine a few theories that attempt to shape good faith into a coherent and workable framework.

But in light of recent developments in Delaware law, the nature of the procedural landscape in which good faith is litigated may end up becoming more important than the exact definition of good faith in determining whether a particular director will be subject to monetary damages. With an eye toward the practical effects of fiduciary duty jurisprudence, the paper follows the path of a typical shareholder lawsuit from injury to judgment, noting where good faith has combined with other state and federal developments to change the fortunes of plaintiff shareholders and defendant directors.

I conclude that recent developments in federal and state law, and in the rules of Self-Regulatory Organizations ("SRO's"), have had the cumulative effect of substantially altering Delaware's litigation playing field in favor of shareholder plaintiffs. By recognizing a cause of

⁹ See *In re The Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003) [hereinafter *Disney II*].

action against directors who abdicate their fiduciary responsibilities, Delaware courts have made it virtually impossible for directors who breached their duty of care to win dismissals of shareholder lawsuits on the pleadings. An increasing number of fiduciary duty claims can be expected to survive a motion to dismiss, thereby raising the settlement value of such claims. Furthermore, those directors who fail to settle may bear a heavy evidentiary burden at trial. In sum, the near-term effect of recent Delaware corporate jurisprudence will be to increase the number of settlements and judgments in favor of plaintiffs.

I. The Rise and Fall of the Duty of Care as a Cause for Director Liability

Although the duty of care has long been an element of Delaware corporate law, it is not considered to be more than an “aspirational and unenforceable standard” in the context of suits for monetary damages against directors.¹⁰ But Delaware’s laxity with regard to the duty of care has at least one glaring exception. In *Smith v. Van Gorkom* the Delaware Supreme Court overturned the Chancery Court’s dismissal of a complaint that accused the directors of the Trans Union Corporation of breaching their duty of care in the course of approving a merger.¹¹ The court noted that the defendants had not been accused of “fraud, bad faith, or self-dealing,” but concluded that loyalty and good faith alone were insufficient.¹² In addition, directors were obligated to reasonably inform themselves of all relevant information before making important corporate decisions, and could be held personally liable for grossly negligent failures to live up to this obligation.¹³

The reaction to *Van Gorkom* was swift and overwhelmingly negative. Although the Delaware Supreme Court had concluded that the directors were grossly negligent, most observers believed that the conduct in question at worst amounted to simple negligence.¹⁴

¹⁰ Jones, *supra* note 1, at 647-48; William T. Allen, Jack B. Jacobs, & Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. L. REV. 1287, 1290 (Aug. 2001) [hereinafter “*Function over Form*”]; see also Charles R.T. O’Kelley & Robert B. Thompson, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS 239 (Aspen Publishers 4th ed. 2003) (describing the search for cases finding liability for breaches of the duty of care in industrial corporations “as akin to ‘a search for a very small number of needles in a very large haystack’”) (quoting Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968)).

¹¹ 488 A.2d 858, 864 (Del. 1985).

¹² *Id.* at 873.

¹³ *Id.* at 877.

¹⁴ Jones, *supra* note 1, at 647 (“*Van Gorkom*...has been almost uniformly criticized.”); see also, e.g., *Function Over Form*, *supra* note 10, at 1300; David Rosenberg, *Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach*, 29 DEL. J. CORP. L. 491, 496-97 (2004). But see Jonathan R. Macey & Geoffrey P. Miller, *Trans Union Reconsidered*, 98 YALE L.J. 127, 128 (1988) (arguing that *Van Gorkom* was neither surprising nor threatening when viewed as a takeover case); Mark J. Roe, *Delaware’s Competition*, 117 Harvard L. Rev. 588, 633 n.183 (2003) (speculating that the Enron and Worldcom debacles may have been prevented if “*Van Gorkom* had survived”).

Insurance companies “sharply increased their premiums,” and even threatened to stop underwriting Directors’ and Officers’ (D&O) liability insurance.¹⁵ Sensing a potential corporate flight from the Delaware, the state legislature enacted Section 102(b)(7), allowing directors to be exculpated from liability for all breaches of the duty of care.¹⁶ Most corporations quickly took advantage of the new statute,¹⁷ thus rendering the duty of care mostly unenforceable by litigation.¹⁸

II. The Dawn of the Post-Enron Era

Although the duty of care no longer plays a prominent role in Delaware suits for monetary damages, in recent years the Delaware courts appear to have expanded the duties of good faith and loyalty in ways that cast doubt on Section 102(b)(7)’s continued ability to effectively shield directors from liability.¹⁹ Most commentators believe recent cases, at least when viewed collectively, represent a shift in Delaware fiduciary duty law in favor of

¹⁵ *Function Over Form*, *supra* note 10, at 1300 n.49.

¹⁶ See Rosenberg, *supra* note 14, at 497 (“Delaware did not become the center of American corporate law by ignoring the needs and worries of corporate directors.”); see also Sean Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L. J. (forthcoming 2005) (manuscript of July 17, 2005 at 62 n.260) <http://ssrn.com/abstract=728431> (noting that the threat of corporations leaving Delaware was made credible by Indiana’s prior enactment of an exculpation statute).

¹⁷ William T. Allen, Jack B. Jacobs & Leo E. Strine, *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and its Progeny as a Standard of Review Problem*, 96 NW. U. L. REV. 449, 463 (2001-2002) [hereinafter “*Critique of Van Gorkom*”]; see also REV’D MODEL BUS. CORP. ACT §202(b)(4) (2002).

¹⁸ However, the statute does not preclude suits for injunctive relief. *Malpiede v. Townson*, 780 A.2d 1075, 1095 (Del. 2001). Nor does it apply retroactively. §102(b)(7); see also *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 350-51 (Del. 1993) (applying the duty of care to a transaction that predated Section 102(b)(7)’s enactment).

Most importantly, Delaware law permits exculpation for directors, but not officers. See §102(b)(7). At the time of Section 102(b)(7)’s enactment, this discrepancy could be explained by the fact that the Delaware Court of Chancery did not have jurisdiction over officer defendants. However, a recent amendment to the Delaware Code now enables the Court of Chancery to exercise personal jurisdiction over corporate officers, thereby leaving them unprotected from liability for breaches of the duty of care. See S.B. 126, 142d Gen. Assem., Reg. Sess. (Del. 2003) (enacted) (codified as amended at DEL. CODE ANN. tit. 10, § 3114).

¹⁹ Three current and former Delaware judges have doubted the continued effectiveness of Section 102(b)(7). *Critique of Van Gorkom*, *supra* note 17, at 462-64.

shareholder plaintiffs.²⁰ According to these commentators, the shift began as Enron and WorldCom brought corporate governance to the nation's attention, prompting the federal government and the national securities exchanges to regulate what had previously been the exclusive terrain of state corporate law.²¹ Seeking to protect its turf from additional federal preemption, the Delaware judiciary has suddenly begun to enforce fiduciary duties with uncharacteristic vigor.²²

On the other hand, at least one Delaware judge rejects the notion that the courts respond to current events, even when those events present a threat of federal preemption. Chancellor Chandler writes:

"Judges...decide cases based on the particularized facts before them, not on whether it will affect the competitive position of the state via other competitors for corporate charters...And in a larger sense, I also think academics sometimes miss the point that judges are not legislators, and they are not given a commission to change the laws based on the headlines of the day."²³

Chancellor Chandler's opinion is at least partly shared by E. Norman Veasey, a former Chief Justice of the Delaware Supreme Court, who denies that Delaware's "substantive law

²⁰ Between June of 2002 and the spring of 2004, the Delaware Supreme Court overruled six Chancery Court decisions, in each case reversing a chancery decision that had favored director defendants. Jones, *supra* note 1, at 625 (viewing the reversals as a "sharp departure" from earlier practice); Roe, *supra* note 14, at 643; Sale, *supra* note 1, at 459-60.

²¹ For a detailed overview of the intersections between state fiduciary duty law and the post-Enron federal regulatory regime, see generally Lyman P.Q. Johnson & Mark A. Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149 (2004). In all fairness to Delaware, it should be noted that neither Enron nor Worldcom were Delaware corporations. Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, REGULATION, Spring 2003, at 30.

²² Jones, *supra* note 1, at 645 (concluding that the "trend toward stricter judicial scrutiny of director decision-making" reflects "the tenor behind judicial pronouncements about the risk of federal preemption"); see also Roe, *supra* note 14, at 643.

²³ E-mail from William B. Chandler III, Chancellor, Delaware Court of Chancery, to Renee M. Jones, Assistant Professor, Boston College Law School (Nov. 6, 2003) reprinted in Jones, *supra* note 1, at 662-63 n.279. But see William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 1005 (2003) (seeing changes in federal law and in national exchange listing requirements as "an invitation for the states to join as full partners in the creative process of reform") [hereinafter *New Federalism*].

has...changed.”²⁴ Rather, Veasey attributes recent Delaware cases to improved pleading by shareholder plaintiffs, assuring directors that “the legal reality today is identical to the legal reality a year ago.”²⁵ But in an earlier forum, he candidly acknowledged the need for Delaware courts to adopt its corporate law to a new era, stating that “[i]f we don’t fix it, Congress will, but I hope they’ve gone as far as they’re going to have to go.”²⁶

Whether or not Delaware fiduciary duty law has truly shifted is beyond the scope of this article. But without a doubt, many officers and directors perceive themselves as being far more vulnerable to suit than they were five years ago.²⁷ The remainder of this article explores the legal doctrines behind the current perception.

III. Evolving Notions of Good Faith

Of all the post-Enron developments in Delaware corporate law, none has generated more attention, nor created more uncertainty, than the prospect of holding directors liable solely for breaching their duty of good faith. Of course, good faith did not emerge out of nowhere with the turn of the 21st century. It has long played a role in contract law as an implied and non-waiveable obligation of all parties to adhere “to an agreed common purpose” and to act

²⁴ E. Norman Veasey, Counseling Directors in the New Corporate Culture, Address Before the Sixteenth Tulane Corporate Law Institute (Mar. 4, 2004), in 4 BUS. LAWYER 1447, 1449 (Aug. 2004).

²⁵ *Id.*

²⁶ Charles Elson, *What’s Wrong with Executive Compensation?*, HARVARD BUS. REV. (Jan. 2003), at 77; see also Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 BUS. LAW. 1371, 1372, 1401-02 (Aug. 2002) (highlighting the dangers of overzealous reform, but acknowledging the possibility that key aspects of corporate law could be federalized).

²⁷ Veasey, *supra* note 24, at 1447 (“There is talk of storm clouds, revolution, transition, sea change, and the like.”); Gary W. Marsh & Petrina Hall, *The Many Faces of Directors’ Fiduciary Duties*, AMER. BANKR. INST. J. 14 (Sept. 2003), at 54 (stating that a recent Delaware case “has many corporate directors concerned about their own personal liability when making decisions on behalf of their corporations”).

The liability concerns of directors were reflected in the choice of topics for the recent Directors’ Education Institute at Duke University. At least half of the sessions, including many of the best-attended, were devoted to liability, regulatory compliance, and disclosure issues. See DUKE UNIV. GLOBAL CAPITAL MARKETS CENTER, PROGRAM FOR THE DIRECTORS’ EDUCATION INST. (March 16-18, 2005), at 3, available at www.DukeDEI.org (last accessed Mar. 29, 2005) (on file with author).

“consistently with the justified expectations of the other party.”²⁸ Nor was the concept new to corporation law, at least as an aspiration directorial obligation, or as one of a litany of presumptions underlying the business judgment rule.²⁹

But bad faith was not seen as an independent basis for director liability until recently. In *Caremark*, then-Chancellor Allen suggested that “a sustained or systematic failure of the board to exercise oversight...will establish the lack of good faith that is a necessary condition to liability.”³⁰ This suggestion was significant because the obligation to keep oneself reasonably informed of a corporation’s activities had traditionally fallen under the duty of care.³¹ Furthermore, the board’s failure to monitor could not be characterized as disloyalty because it did not place the interests of the board-members ahead of the interests of the corporation and its shareholders.³² By characterizing a sustained failure to monitor as bad faith, the court placed an entire category of activity (or omission) beyond the protective grasp of Section 102(b)(7).

In a case applying Illinois law, but which drew heavily from Delaware corporate law, the United States Court of Appeals for the Seventh Circuit also recognized an independent duty of good faith.³³ The defendant directors in this case had allegedly failed to respond, over the course of six years, to FDA warnings, “inspections...and notice in the press” of the company’s

²⁸ *E.I. Dupont de Nemours & Co. v. Pressman*, 679 A.2d 436, 443 (Del. 1996) (quoting *Restatement (Second) of Contracts* §205, cmt. a. (1979)).

²⁹ *See, e.g., Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (“It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, *in good faith* and in the honest belief that the action taken was in the best interests of the company.”) (emphasis added); *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939) (holding that Delaware law “demands of an officer or director the utmost good faith in his relation to the corporation which he represents”); *Barnes v. Andrews*, 298 F. 614, 618 (S.D.N.Y. 1924) (observing that directors, under New York law, must “faithfully give such ability as they have to their charge”).

³⁰ *In re Caremark Intern. Inc. Derivative Litigation*, 698 A.2d 959, 971 (Del. Ch. 1996); *see also McCall v. Scott*, 250 F.3d 997, 1001 (6th Cir. 2001) (holding, under Delaware law, that directors’ good faith could be brought into doubt by allegations of “intentional ignorance of and willful blindness to red flags signaling fraudulent practices”).

³¹ *See, e.g., Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 367 (Del. 1993); *Hoye v. Meek*, 795 F.2d 893, 895 (10th Cir. 1986); William Meade Fletcher, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* §1034.80 (updated Nov. 2004).

³² *See Cede*, 634 A.2d at 361 (describing loyalty as a demand that “there be no conflict between duty and self-interest”) (quoting *Guth v. Loft*, 5 A.2d 503, 270 (Del. 1939)).

³³ *In re Abbot Laboratories Derivative S’holder Litig.*, 325 F.3d 795, 811 (7th Cir. 2003).

noncompliance with federal regulations.³⁴ According to the complaint, the directors' sustained inattention "resulted in the largest civil fine ever imposed by the FDA and the destruction and suspension of products which accounted for approximately \$250 million in corporate assets."³⁵ The court reasoned that the directors' conduct as described in the complaint amounted to "a conscious disregard of known risks, which...cannot have been undertaken in good faith."³⁶

A. Good Faith as an Independent Obligation Versus Good Faith as a Subset of Loyalty

The conception of good faith advanced in *Caremark* was explicitly endorsed by former Chief Justice Veasey,³⁷ and the court has on multiple occasions characterized good faith, along with care and loyalty, as forming a "triad" of fiduciary duties.³⁸ In addition, Section 102(b)(7)(i) forbids exculpation for breaches of the duty of loyalty, while a separate clause mandates liability "for acts or omissions not in good faith."³⁹ To hold that good faith is a subset of loyalty would reduce a separately numbered statutory clause to mere surplusage, thus violating traditional "canons of statutory construction."⁴⁰

³⁴ *Id.* at 809.

³⁵ *Id.*

³⁶ *Id.* at 811 (quoting *McCall v. Scott*, 250 F.3d 997, 1001) (6th Cir. 2001).

³⁷ Veasey, *supra* note 24, at 1455.

³⁸ *Emerald Partners v. Berlin*, 787 A.2d 85, 91 (Del. 2001); *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000) ("[G]ood faith...is a key ingredient of the business judgment rule."); *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998); *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993). *But see id.* at 368 n.36 (equating good faith with loyalty).

³⁹ §102(b)(7)(ii). Good faith has been codified in several areas of the Delaware Corporation Law. *See, e.g.*, DEL. CODE ANN. tit. 8, §141(e) (2001) (permitting directors to rely "*in good faith* upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation...") (emphasis added); DEL. CODE ANN. tit. 8, §145 (2001) (allowing corporations to indemnify officers, directors, or agents who act in good faith).

⁴⁰ Griffith, *supra* note 16, at 15 (citing R. DICKERSON, *THE INTERPRETATION AND APPLICATION OF STATUTES* 233 (1975)). Had the Delaware legislature sought to subsume the duty of good faith into the duty of loyalty, it had ample examples from other jurisdictions of how to do so. *See, e.g.*, MOD. BUS. CORP. ACT. §2.02(b)(4)(B) (2002) (omitting any mention of good faith but prohibiting exculpation for, *inter alia*, "an intentional infliction of harm on the corporation or the shareholders").

But the notion of good faith as a separate fiduciary duty is far from universally approved within Delaware's judiciary.⁴¹ On the contrary, Chancellor Chandler,⁴² Vice Chancellor Strine⁴³ and former Vice-Chancellor Jacobs⁴⁴ have characterized the duty of good faith as subsidiary to the duty of loyalty, thus negating the possibility that a director could be held liable for bad faith without satisfying the requirements for disloyalty. According to this view, "while it is possible to act in good faith and not be loyal, 'there is no case in which a director can act in subjective bad faith towards the corporation and act loyally.'"⁴⁵

Perhaps it was inevitable that the Court of Chancery would eventually yield to its jurisdictional superiors in the state Supreme Court. In a recent Delaware case arising out of the expensive, short-lived, and rocky tenure of a president of the Walt Disney Company, the Chancellor recognized the existence of a separate duty of good faith.⁴⁶ In denying a motion to dismiss a derivative complaint, the court held that the directors' alleged failure to exercise "any business judgment or [to make] any good faith attempt to fulfill" their fiduciary duties could subject them to personal liability for monetary damages.⁴⁷ The directors could be held liable despite the fact that their loyalty was not in question, and even though they were protected from

⁴¹ See Rosenberg, *supra* note 14, at 505 (concluding that the Delaware Court of Chancery is in "open revolt" against the good faith jurisprudence of the state supreme court).

⁴² E.g., Orman v. Cullman, 794 A.2d 5, 14 n.3 (Del. Ch. 2002). But see generally *Disney II*, 825 A.2d 275 (denying defendants' motion to dismiss on the ground that bad faith had been adequately pleaded, even though plaintiffs had not alleged disloyalty); see also *infra*, notes 46-48 and accompanying text.

⁴³ *In re Gaylord Container Corp. Shareholders Litig.*, 753 A.2d 462, 476 n.41 (Del. Ch. 2000) (labeling good faith as "subsidiary" to loyalty). But see Strine, *supra* note 26, at 1385-86 (correctly predicting that courts will be called upon to assess the good faith of directors who had no "financial interest in the underlying conduct").

⁴⁴ *Emerald Partners v. Berlin*, Civ. Action No. 9700 (Feb. 7, 2001), 2001 WL 115340, at *25 n.63 (observing that good faith "does not exist separate and apart from the fiduciary duty of loyalty"), *overruled in part on other grounds by* 787 A.2d 85 (Del. 2001). Justice Jacobs was later appointed to the Delaware Supreme Court. See also *Emerald Partners v. Berlin*, No. 9700, 2003 WL 21003437, at *39 n.133 (Del. Ch. Apr. 28, 2003), *aff'd*, 840 A.2d 641 (table) (Del. 2003); Griffith, *supra* note 16, at 6 n.11 (discussing Delaware decisions that subsume good faith within loyalty); Rosenberg, *supra* note 14, at 500-01 (same).

⁴⁵ See Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003).

⁴⁶ *Disney II*, 825 A.2d 275 (Del. Ch. 2003).

⁴⁷ *Id.* at 287.

duty of care claims by Section 102(b)(7).⁴⁸ In effect, the court recognized a derivative cause of action against loyal directors whose acts or omissions “are either ‘not in good faith’ or ‘involve intentional misconduct.’”⁴⁹

Applying this cause of action to the complaint, the court observed that the plaintiffs’ allegations,

“if true, do more than portray directors who, in a negligent or grossly negligent manner, merely failed to inform themselves or to deliberate adequately about an issue of material importance to their corporation. Instead, the facts alleged...suggest that the defendant directors *consciously and intentionally disregarded their responsibilities*, adopting a “we don’t care about the risks” attitude concerning a material corporate decision.”⁵⁰

Disney II has generated numerous academic commentaries devoted to explaining and delimiting the duty of good faith.⁵¹ The following section will summarize a number of theories that seek to explain how the duty of good faith can exist separately from the duties of care and loyalty. The paper will then leave the academic laboratory to explore the duty of good faith in its own habitat, namely the Delaware judicial system. In other words, the paper will explore what

⁴⁸ See *id.* at 286-87 (observing that the Disney board was “disinterested and independent”).

⁴⁹ *Id.* at 290 (quoting §102(b)(7)(ii)); see also *Production Resources Group, L.L.C. v. N.C.T. Group, Inc.*, 863 A.2d 772, 800 (Del. Ch. 2004) (holding that a board could be held liable for bad faith conduct even though it was “putatively independent”).

⁵⁰ *Id.* at 289 (emphasis in original). In an apparent sign of approval, the Delaware Supreme Court later adopted language from *Disney II*. *Emerald Partners v. Berlin*, 840 A.2d 641 (table), No. 295, 2003 WL 23019210, at *1 (Del. Dec. 23, 2003).

⁵¹ Most of the academic reviews appear to be favorable. See generally, e.g., Sale, *supra* note 1; Rosenberg, *supra* note 14; Griffith, *supra* note 16. But see Matthew R. Berry, Note, *Does Delaware’s Section 102(b)(7) Protect Reckless Directors from Personal Liability? Only if Delaware Courts Act in Good Faith*, 79 WASH. L. REV. 1125, 1140 (2004) (criticizing *Disney II* as effectively equating bad faith with recklessness, a level of conduct that should have been exculpated under Section 102(b)(7)).

The judicial reaction to *Disney II* has been mixed. On the one hand, the Court of Chancery has continued to resist treating good faith as a separate fiduciary duty, mostly declining to decide whether deliberate indifference should be categorized as bad faith, disloyalty, or both. See, e.g., *Official Committee of Unsecured Creditors of Integrated Health Svcs., Inc. v. Elkins*, No. Civ.A. 20228-NC (Del. Ch., Aug. 24, 2004), 2004 WL 1949290, at *9-10; *Emerging Communications, Inc. S’holders Litig.*, No. Civ.A. 16415 (Del. Ch., June 4, 2004), 2004 WL 1305745, at *39 n.184. On the other hand, it has shown a willingness to hold directors accountable for intentionally and consciously disregarding their responsibilities, even if it has hesitated to definitively label the basis for liability as either bad faith or disloyalty. See, e.g., *Elkins*, 2004 WL 1949290, at *12; *Emerging Communications*, 2004 WL 1305745, at *39 n.184. Thus, the Chancery court’s “open revolt” against the “triad” of duties may amount to little more than an argument over semantics. See Rosenberg, *supra* note 14, at 505; Discussion, *supra* note 41 and accompanying text.

the practical effect will be of adding good faith to the multitude of procedural and substantive doctrines that comprise Delaware's corporate law.

B. Good Faith as an Academic Debate

In one of the first attempts to separate good faith “from what a defendant might prefer to characterize as a care-based situation,” Sale noted that issues of good faith could arise from “an obvious or egregious violation, resulting from abdication, subversion, or deliberate indifference....”⁵² The characterization of good faith as an egregious violation of the duty of care is an unfortunate development in recent case law, as it creates needless uncertainty regarding how “egregious” an activity must be before it can be categorized as bad faith rather than lack of care.

Even without the protections of Section 102(b)(7) directors would not face liability for monetary damages unless they acted or failed to act with gross negligence.⁵³ This standard already causes much hair-splitting in distinguishing the requisite gross negligence from mere “ordinary” negligence.⁵⁴ To again split the remaining half-hairs into “simple” gross negligence and “egregious” gross negligence would force the Delaware judiciary to make incoherent and artificial distinctions.⁵⁵ Most likely, no conduct would remain outside of the business judgment

⁵² Sale, *supra* note 1, at 488-89; see also Elkins, 2004 WL 1949290, at *9 n.37 (speculating that *Disney II* may be explained as a “duty of care claim that is so egregious—that essentially alleges the Board abdicated its responsibility to make any business decision—that it” raises questions about the defendants’ good faith); Beam v. Stewart, 833 A.2d 961, 984-85 (Del. Ch. 2003) (same).

⁵³ Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

⁵⁴ The most concise (and arguably the most helpful) distinction that the author is aware of was made by Judge Magruder, who described Chief Justice Rugg’s definitions of negligence, gross negligence, and recklessness as amounting to conduct by “a fool, a damn fool, and a God-damn fool,” respectively. George Christie, *Vagueness and Legal Language*, 48 MINN. L. REV. 885, 899 (1964) (quoting HARV. L. RECORD, Apr. 16, 1959, at 7).

⁵⁵ Of course, the duties of care, loyalty and good faith can occasionally overlap. However, one duty cannot be expanded to the point of swallowing another whole without eviscerating legislative and judicial acknowledgements of the existence of three separate duties. See Discussion, *supra* note 40 and accompanying text.

rule that could be protected under a duty-of-care exculpation provision.⁵⁶ Furthermore, the Delaware Supreme Court counsels against defining bad faith as an extreme lack of care, stating that “[c]onsiderations of good faith are *irrelevant* in determining” whether directors exercised “informed business judgment.”⁵⁷

On the other hand, defining bad faith as an egregious breach of the duty of care would make sense if one accepts the view of the majority of commentators that *Van Gorkom* wrongly applied duty of care analysis to conduct that at worst amounted to simple negligence.⁵⁸ Under such a view, the good faith exception to director exculpation could be seen as preserving liability for breaches of the duty of care for conduct that is truly grossly negligent, but not for conduct evincing the same level of culpability as the activity described in *Van Gorkom*.⁵⁹ However, this

⁵⁶ Cf., *Critique of Van Gorkom*, *supra* note 17, at 457 (noting that shareholders as a whole will suffer if director liability is predicated “on the ground that the investment was too risky...foolishly risky! stupidly risky! egregiously risky!—you supply the adverb...” (internal parentheses omitted) (quoting *Gagliardi v. TriFoods, Int’l, Inc.*, 683 A.2d 1049, 1052 (Del. Ch. 1996)).

⁵⁷ *Van Gorkom*, 488 A.2d at 889 (emphasis added). But the fact that bad faith is not a function of the egregiousness of a well-motivated business decision does not mean that courts cannot consider the egregiousness of a decision in evaluating whether the defendants were truly well-motivated. *In re J.P. Stevens & Co. S’holders Litig.*, 542 A.2d 770, 780-81 (Del. Ch.1988) (“A court may, however, review the substance of a business decision made by an *apparently* well motivated board for the limited purpose of assessing whether that decision is so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.”) (quoted in John L. Reed & Matt Neiderman, “*Good Faith*” and the Ability of Directors to Assert §102(b)(7) of the Delaware General Corporation Law as a Defense to Claims Alleging Abdication, Lack of Oversight, and similar Breaches of Fiduciary Duty, 29 DEL. J. CORP. L. 111, 123-24 (2004)).

⁵⁸ See Discussion, *supra*, note 14 and accompanying text.

⁵⁹ For an example of how §102(b)(7) could eviscerate *Van Gorkom*’s interpretation of gross negligence while still leaving room for liability under a theory of bad faith, see *Apple Computer, Inc. v. Exponential Tech., Inc.*, No. 16315, 1999 WL 39547 (Del. Ch. Jan. 21, 1999). There the court held that a board’s failure to “even attempt to comply with its statutory obligation” to obtain shareholder approval before selling substantially all of the corporation’s assets would constitute gross negligence. *Id.* at *7. The Exponential board’s conduct would probably not have been classified as gross negligence under traditional standards because the allegedly wrongful sale occurred in the wake of cataclysmic external events that largely obliterated any chance that the corporation would profit from its former business. *Id.* at *5. Thus, the sale was arguably a reasonable, or at most an ordinarily negligent attempt to quickly dispose of the corporation’s assets before they began to drain the corporate treasury. See *id.*

Nonetheless, after comparing the allegations in the complaint with the alleged conduct of the board in *Van Gorkom*, the court concluded that the complaint raised a sufficient inference of gross negligence on the part of Exponential’s board to state a claim for breach of the duty of care. *Id.* at *7 n.30 (“If [the Trans Union] board’s uninformed, hasty approval of a merger constitutes gross negligence in breach of its duty of care under 8 Del. C. §§ 141 & 251(b), it follows that [Exponential’s] failure to hold a shareholder vote under §271 (and §141) would constitute gross negligence in violation of the board’s duty of care....”). However, the court dismissed the complaint because the board-members were exculpated from liability for duty of care violations under Section 102(b)(7). *Id.* at *8.

view of Section 102(b)(7) does not comport with the text of the statute, which unambiguously forbids exculpation for bad faith, but not for lack of care. Furthermore, in *Brehm* the Delaware Supreme Court appears to have adopted a more rigorous standard of gross negligence than the one applied in *Van Gorkom*, thus making it unnecessary to use good faith as a dividing line between exculpable and “truly” grossly negligent duty of care violations.⁶⁰ Therefore, egregiousness is probably not an adequate dividing line between mere duty of care violations and bad faith.⁶¹

A far more promising view of good faith looks to the motives and intentions of the accused to determine whether his or her conduct amounted to bad faith. David Rosenberg proposes that good faith be seen as a “contractarian” doctrine that requires parties to “adhere to the terms of the contract without knowingly attempting to evade those obligations to which [they have] voluntarily submitted [themselves].”⁶² When applied to a corporate director, the duty of good faith thus forbids any act or omission that “he knows violates the spirit of the obligations to which he has submitted himself by agreeing to act as a corporate director.”⁶³ In other words,

“[a] director’s duty of good faith is...the obligation to try to perform his duties according to his understanding of what the corporate charter and existing law demand from him.... [H]e must do his best to use care; and he must honestly try to carry out any other promise he has made to those who have entrusted him with control of their corporation.”⁶⁴

⁶⁰ See *Brehm v. Eisner*, 746 A.2d 244, 249, 259 (Del. 2000) (holding that the complaint failed to allege gross negligence even though the defendants’ approval of a “luxurious” executive compensation package was carried out using lax procedures that “were hardly paradigms of good corporate governance practice”); *Critique of Van Gorkom*, *supra*, note 17, at 464-65 (viewing *Brehm* as a signal of the end of “the de fact misapplication of the gross negligence standard of review).

⁶¹ *Accord Sale*, *supra* note 1, at 489 (“Presumably...good faith claims must be different from negligence and gross negligence.”).

⁶² Rosenberg, *supra* note 14, at 508; see also Sale, *supra* note 1, at 489 (suggesting that a claim of bad faith “requires motive-based allegations of severely reckless or seemingly intentional behavior”).

⁶³ *Id.* at 509. But see *In re The Walt Disney Company Derivative Litigation*, C.A. No. 15452, 2005 WL 2056651, *35 n.449 (Del. Ch. Aug. 9, 2005) (distinguishing the duty of good faith owed by fiducies from the duty of good faith owed by parties to a contract) [hereinafter: *Disney III*].

⁶⁴ *Id.* at 510, 513; see also Strine, *supra* note 26, at 1393 (predicting that plaintiffs will question the good faith of directors who consciously fail to devote “sufficient attention to [their] duties”).

Rosenberg's contractarian approach to good faith comports with *Disney II*, which recognized a cause of action against directors who "*knew* that they were making material decisions without adequate information and without adequate deliberation, [but]...simply did not care if the decision caused the corporation and its stockholders to suffer injury or loss."⁶⁵ By focusing on whether a director honestly tries to fulfill her duties, Rosenberg provides an apparently coherent framework in which good faith can be recognized as a separate fiduciary obligation.

Rosenberg's thesis also meshes with good faith's tendency to expand the reach of non-exculpable conduct to include passive activities or omissions, such as a board's failure "to exercise *any* business judgment" or "to make *any* good faith attempt to fulfill [its] fiduciary duties."⁶⁶ Delaware courts have generally limited findings of disloyalty to situations where defendants actively worked to disadvantage their firms by, for example, usurping a corporate opportunity⁶⁷ or engaging in an interested transaction.⁶⁸ In contrast, the duty of good faith can punish inaction, provided that the failure to act was motivated by a conscious disregard for the corporation's welfare.⁶⁹ The effect of characterizing good faith in terms of abdication of duty has been to focus plaintiffs' lawyers attention on directors who were either apathetic to their duties, or who were too overloaded with other responsibilities to have possibly focused enough

⁶⁵ *Disney II*, 825 A.2d at 289 (emphasis in original).

⁶⁶ *Id.* at 278.

⁶⁷ *See, e.g.,* *Yiannatsis v. Stephanis by Sterianou*, 653 A.2d 275, 278-79 (Del. 1995).

⁶⁸ *See, e.g., In re* Emerging Communications S'holders Litig., No. Civ.A 16415, 2004 WL 1305745, at *39 (Del. Ch. June 4, 2004).

⁶⁹ *E.g., Disney II*, 825 A.2d at 278 (holding that directors' good faith can be placed in doubt by "[a]llegations that [they] abdicated all responsibility to consider appropriately an action of material importance to the corporation"); *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996) (suggesting that a board's "sustained or systemic failure" to monitor compliance with regulatory requirements could raise doubts about the board's good faith); *see also Disney III*, C.A. No. 15452, 2005 WL 2056651, *35 (Del. Ch. Aug. 9, 2005) (noting that sloth could constitute bad faith if it amounted to "a systematic or sustained shirking of duty").

attention on the corporations they served, and who therefore allowed their corporation to be injured.⁷⁰

But although Delaware courts have occasionally described conduct that could amount to bad faith,⁷¹ they have never attempted to comprehensively establish where good faith begins or ends. Therefore, the Delaware courts have not foreclosed the possibility of applying good faith to situations that do not fall into Rosenberg's (or anyone else's) model. According to one commentator, the judicial open-endedness is no accident, but is a direct consequence of the fact that good faith only has meaning "as a rhetorical device" and not as a "substantive standard."⁷² In Griffith's view, the duties of care and loyalty are essentially guideposts that point courts

⁷⁰ See, e.g., *Disney II*, 825 A.2d 287-88 (holding that the Disney board's good faith was placed in doubt by the allegation that it spent less than an hour discussing a gigantic compensation agreement for its new president and did not appear to have met at all to discuss his no-fault termination barely a year later). In the wake of the Enron and Worldcom scandals much attention was paid to allegedly docile and indifferent boards who allowed "imperial" CEO's to act with impunity. See Arthur Levitt Jr., *The Imperial CEO Is No More*, WALL ST. J., Mar. 17, 2005, at A16.

A number of regulators and judges have signaled that the law demands a board to be far more engaged and empowered. For example, in a recent roundtable discussion then-Chief Justice Veasey challenged directors "who are supposed to be independent [to] have the guts to be a pain in the neck and act independently." Elson, *supra* note 26, at 76; see also Strine, *supra* note 26, at 1391 (doubting that Enron's audit committee could have effectively carried out its responsibilities when it only met five times in a year); Remarks of Robert K. Herdman, Chief Accountant of the S.E.C., at the Tulane Corp. Law Inst. (Mar. 7, 2002) (opining that "spending an hour together three and four times a year probably is not sufficient" time for an audit committee to adequately perform its functions.") (quoted in Strine, *supra* note 26, at 1389 n.55).

Commentators have expressed varying views on the wisdom of recent state, federal, and SRO mandates that directly or indirectly compel board-members of public corporations to become more engaged. For a general discussion, see Strine, *supra* note 26, at 1385-95; see also Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards*, 30 SEC. REG. L. J. 370, 376 (2002) (noting that increased time demands have made it "increasingly difficult" for public corporations to "recruit and retain qualified independent directors"). On the other hand, some researchers have noted a positive correlation between firms with overly busy boards, who therefore lack sufficient time to devote to the enterprise, and weak corporate governance. See Eliezer M. Fich & Anil Shivdasani, *Are Busy Boards Effective Monitors?* (October 2004) EUROPEAN CORP. GOV. INST., Finance Working Paper No. 55/2004, at 29, available at <http://ssrn.com/abstract=607364> (defining "busy" boards as "those in which a majority of outside directors hold three or more directorships").

⁷¹ See, e.g., *Disney II*, 825 A.2d at 289; *In re Caremark Intern. Inc. Derivative Litigation*, 698 A.2d 959, 971 (Del. Ch. 1996).

⁷² Griffith, *supra* note 16, at 7. It should be noted that Griffith did not intend to use the term "rhetorical device" derogatively. *Id.* at 8.

toward a more fundamental principle of corporate law, namely, “[a]re the directors doing their best in acting for someone else?”⁷³

The duty of good faith becomes relevant when directors violate this fundamental principle, but do so “without checking all of the boxes for liability under either” loyalty or good faith.”⁷⁴ In such instances liability may be found by resorting to a mode of thinking labeled “thaumatrope analytics,” in which the court shuffles between the concepts of care and loyalty until a blurry picture of overall wrongdoing is created that adds up to bad faith.⁷⁵

IV. Good Faith in the Context of Delaware Litigation

The above discussion summarizes the thoughtful and nuanced debate that *Disney II* has inspired within the academic community about the meaning of good faith. But such subtle distinctions will ultimately mean little in actual fiduciary duty litigation because good faith does not operate in a vacuum, but in the intricately woven network of procedural rules, shifting burdens of proof, and federal influences that form the backdrop of Delaware corporate law. When courts apply good faith to real cases while following the procedural and evidentiary rules that pertain to Delaware corporate law, any theory that sees good faith as more than a mere subset of loyalty will result in some directors being forced to pay damages, regardless of the existence of an exculpation provision, for duty of care violations. This is not necessarily because

⁷³ *Id.* at 42; see also Ehud Kamar, *Shareholder Litigation Under Indeterminate Corporate Law*, 66 U. CHI. L. REV. 887, 891 (1999) (arguing that the essential message of Delaware corporate law “is that corporate fiduciaries simply must do their utmost to promote shareholder interests”).

⁷⁴ Griffith, *supra* note 16, at 43.

⁷⁵ *Id.* at 36-42. A thaumatrope is an optical toy consisting of a disk with two complementary images (such as a man and a horse) on opposite sides. When the disk is hung by a string and spun around an axis, it creates the illusion of a single drawing, such as that of a man riding a horse. *Id.* at 35 (quoting Leon S. Lipson, *The Allegheny College Case*, 23 YALE L. REP. 8, 11 (1977)). Perhaps the most famous example of thaumatrope analytics is the classic Allegheny College case, in which J. Cardozo oscillated between principles of consideration and promissory estoppel in order to hold the defendant liable for breach of contract. See generally *Allegheny Coll. v. Nat’l Chautauqua County Bank of Jamestown*, 159 N.E. 173 (N.Y. 1927); see also Griffith, *supra* note 16, at 35 n.141 (quoting Lipson, *supra*, at 11); *Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 781 (Del. Ch. 2004) (concluding that the facts alleged in “combination generate[] an aroma of fiduciary infidelity”).

care and good faith are theoretically inseparable. On the contrary, Rosenberg's view of good faith is both supported by case law and distinct from care.⁷⁶ But in the context of an actual case, it will be very difficult for a director who failed to exercise due care to prove by a preponderance of the evidence that she nevertheless acted in good faith. Moreover, it will be nearly impossible for her to win a dismissal on the pleadings or summary judgment.

For plaintiffs, the ability to move beyond the pleading stages of a fiduciary duty suit is nearly as valuable as a judgment on the merits, since the settlement value of most suits will be far higher after the denial of a motion to dismiss than when a claim is first filed.⁷⁷ Therefore it is surprising that so little attention has been paid to how a creative plaintiffs' attorney can use both Sarbanes-Oxley and recent Delaware good faith jurisprudence as a tool to bring a case to trial.

This section outlines the procedural landscape facing shareholder plaintiffs with potential claims. To illustrate the background in which bad faith claims will be litigated, the section begins by summarizing the standards of review that pertain to Delaware corporate cases, and then discusses the evidentiary burdens that arise when a defendant presents exculpation as a defense under Section 102(b)(7). It then follows the path of a typical shareholder lawsuit, beginning with pre-filing investigation by the plaintiff and ending at trial. At every stage, an independent duty of good faith will remove rocks and brambles that previously stood in the way of the shareholders' path to recovery.

⁷⁶ See Discussion, *supra* notes 62-70 and accompanying text.

⁷⁷ See Bruce D. Angiolillo, *Settlement Issues in Securities Class Actions: The Defense Perspective in 2004*, 1442 PRAC. L. INST. CORP. HANDBOOK SERIES 297, 303 (Sept.-Oct. 2004) ("Defendants do not want securities class actions settled – they want them dismissed.").

A. Standards of Review and Evidentiary Burdens

A plaintiff shareholder's fate will often depend on which standard of review applies to the claim in question.⁷⁸ In the absence of allegations of breaches of fiduciary duties, most actions or omissions by officers and directors will merit review under the business judgment rule, a “venerable bludgeon that has whacked countless...derivative lawsuits.”⁷⁹ Described by a former Delaware chief justice as “the foundation of our corporate law,”⁸⁰ it forbids courts from second-guessing corporate officers or directors unless they “are interested or lack independence relative to the decision, do not act in good faith, ...or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available.”⁸¹ Under the doctrine of waste, a corporate decision may still be invalidated if it “cannot be attributed to a rational business purpose.”⁸² But such a scenario is at most a theoretical possibility, since in real life a loyal fiduciary who exercises due care in making good faith decisions will not act irrationally.⁸³ Therefore, once a court determines that the business judgment rule applies, the defendants can confidently expect the case to be dismissed.

On the other hand, in certain situations the applicable standard of review is more favorable to plaintiff shareholders. For example, corporate defenses to takeover attempts that would result in a change in control are reviewed under an “intermediate scrutiny” standard.⁸⁴ In

⁷⁸ *Emerald Partners*, 787 A.2d at 89 (“The applicable standard of judicial review often controls the outcome of the litigation on the merits.”). For an in depth examination of the effects of standards of review on Delaware corporate law, see generally *Function over Form*, *supra* note 10.

⁷⁹ John Gibeaut, *Stock Responses: Shareholders Ask for Changes in Corporate Governance, and the Courts are Starting to See it their Way*, ABA JOURNAL 38 (Sept. 2003).

⁸⁰ Veasey, *supra* note 24, at 1454.

⁸¹ *Brehm v. Eisner*, 746 A.2d 244, 264 n.66 (Del. 2000). The duty to examine all material facts essentially restates the duty of care and therefore will have no effect when the defendant is exculpated by a Section 102(b)(7) provision. See *Emerald Partners v. Berlin*, 726 A.2d 1215, 1224 (Del. 1999) (“[W]here the factual basis for a claim *solely* implicates a violation of the duty of care, this Court has indicated that the protections of such a charter provision may properly be invoked and applied.”).

⁸² *Brehm*, 746 A.2d at 264 n.66.

⁸³ *Critique of Van Gorkom*, *supra* note 17, at 452 n.12.

⁸⁴ *Emerald Partners v. Berlin*, 787 A.2d 85, 89 (Del. 2001).

such cases, the court will ask whether the action taken by the target corporation was reasonable in light of the threat posed by the attempted takeover.⁸⁵ The court will not overturn a defensive tactic merely because it would have acted differently in like circumstances, but only because it finds the tactic to have gone beyond the range of reasonable director conduct.⁸⁶

Finally, Delaware courts reserve the most exacting standard of review for corporate acts that involve breaches of fiduciary duty,⁸⁷ or for transactions where the same fiduciary stands on both sides of the table.⁸⁸ In such circumstances, the fiduciaries must “demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain.”⁸⁹ In assessing the entire fairness of a corporate transaction, courts will normally place the burden of persuasion on the defendant, who must prove by a preponderance of the evidence that the act was A) the product of fair dealing, and B) fairly priced.⁹⁰

⁸⁵ See *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1152 (Del. 1990).

⁸⁶ See *id.*

⁸⁷ See *Emerald Partners*, 787 A.2d at 91; *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (holding that when a shareholder provides evidence that directors breached their fiduciary duties, the directors then assume the burden of proving “the ‘entire fairness’ of the transaction...” (quoting *Nixon v. Blackwell*, 626 A.2d 1366, 1376 (Del. 1993)). The entire fairness test is often associated with self-dealing transactions and mergers, perhaps because cases finding breaches of fiduciary duty outside of those contexts are exceedingly rare. However, the language of *Cede* applies by its terms to all breaches of fiduciary duties. *Id.* In fact, in the Disney litigation both the plaintiffs and defendant Michael Ovitz seemed to agree that Ovitz would have had to demonstrate the entire fairness of his compensation if the court had found it to have been the product of a breach his fiduciary duty to the corporation. Compare Reply Brief in Support of Defendant Michael Ovitz's Motion for Summary Judgment §II(A)(3), *In Re The Walt Disney Co. Derivative Litig.*, C.A. No. 15452, 2004 WL 1900551 (Del. Ch. Aug. 6, 2004) (arguing that Ovitz's compensation arrangements were entirely fair to Disney) with Plaintiffs' Post-Trial Brief §III(A), Consolidated C.A. No. 15452-NC, 2005 WL 656216 (Del. Ch. Mar. 6, 2005) (arguing that defendants have failed to establish the entire fairness of Ovitz's compensation arrangements).

⁸⁸ *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983). Entire fairness is also used to determine the validity of stock repurchases that eliminate “a threat to corporate policy” by removing a potentially troublesome shareholder. See *Strassburger v. Earley*, 752 A.2d 557, 571 n.34 (Del. Ch. 2000) (quoting *Bennett v. Propp*, 187 A.2d 405, 409 (Del. 1962)).

⁸⁹ *Weinberger*, 457 A.2d. at 710.

⁹⁰ *Id.* at 710-11. In self-dealing transactions, the burden of persuasion will shift to the plaintiffs if the transaction had been “approved by a fully functioning independent committee of independent directors or by an informed majority of minority stockholders.” *In re Emerging Communications, Inc. S'holders Litig.*, No. Civ.A. 16415 (Del. Ch., June 4, 2004), 2004 WL 1305745, at *10. But even then, the standard of review remains entire fairness. *Emerald Partners*, 787 A.2d at 93 n.52.

B. Sarbanes Oxley, Section 220, and the Drafting of a Well-Pled Complaint

To survive a motion to dismiss, a plaintiff in a derivative suit cannot rely on “conclusory statements or mere notice pleadings” of director wrong-doing, but “must allege *with particularity* facts raising a reasonable doubt that the corporate action being questioned was properly the product of business judgment.”⁹¹ This pleading requirement places “an almost impossible burden” on plaintiffs who, without the benefit of discovery, must plead facts with particularity that often are not public knowledge.⁹²

However, plaintiffs are assisted in surmounting this “almost impossible burden” by Section 220 of the Delaware General Corporation Law, which permits shareholders to inspect the books and records of a corporation for any “proper purpose,” meaning a “purpose reasonably related to [their] interest as [] stockholder[s].”⁹³ The Delaware Supreme Court has held that the investigation of “possible corporation wrongdoing” will be considered a proper purpose,⁹⁴ as long as those seeking information “show, by a preponderance of the evidence, that there is a legitimate chance that their reason for suspecting mismanagement is credible...”⁹⁵ In fact,

⁹¹ *Brehm v. Eisner*, 746 A.2d 244, 254-55 (Del. 2000) (emphasis added); *see also* Del. Ch. Ct. R. 23.1. Alternatively, the plaintiff may allege facts creating a reasonable doubt that the directors were “disinterested and independent.” *Aronson*, 473 A.2d at 814.

⁹² *Brehm*, 746 A.2d at 268 (Hartnett, J., concurring). On the other hand, plaintiffs may in some cases be able to avoid the demand requirements of derivative actions by filing their complaints in the form of a class action. *See* Elliott J. Weiss & Lawrence J. White, *File Early, Then Free Ride: How Delaware Law (Mis)Shapes Shareholder Class Actions*, 57 VAND. L. REV. 1797, 1800 (2004).

⁹³ DEL. CODE ANN. tit. 8, §220(b) (2003). Whether or not plaintiffs have access to such records could easily determine the outcome of a case. For example, the most pertinent allegations in *Disney II* were discovered through a search of corporate records after the plaintiffs’ original complaint had been dismissed for failure to state a claim. 825 A.2d 275, 279 (Del. Ch. 2003) (noting that the search of corporate records produced allegations portraying “a markedly different picture of...corporate processes...than that portrayed in the first amended complaint”).

⁹⁴ *Saito v. McKesson HBOC, Inc.*, 806 A.2d 113, 114 (Del. 2002).

⁹⁵ *Brehm*, 746 A.2d at 267 n.75 (quoting *Security First Corp. v. U.S. Die Casting & Dev. Corp.*, 687 A.2d 563, 567-69 (Del. 1997)).

Delaware courts have criticized plaintiffs on multiple occasions for failing to take full advantage of their rights under Section 220 before initiating legal action.⁹⁶

In addition to the board minutes, memoranda, financial records, and other sources that have traditionally been accessed through Section 220, plaintiffs will inevitably seek to investigate the extensive and potentially fruitful paper trails mandated by the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”). For example, under Sarbanes-Oxley Section 301, corporations are now required to retain records of “complaints received...regarding accounting, internal accounting controls, or auditing matters.”⁹⁷ These files will offer veritable treasure troves of information for imaginative plaintiffs attorneys who suspect a fiduciary of financial misconduct.

Sarbanes Oxley may also co-opt a corporation’s attorneys to act in the service of shareholder plaintiffs through its “up-the-ladder” reporting requirement, since any such reports could potentially become the subject of a Section 220 inquiry.⁹⁸ In fact, the Court of Chancery has even held that a shareholder’s desire to recoup investment losses resulting from an alleged breach of fiduciary duty can constitute sufficient cause to compel disclosure of privileged pre-litigation legal advice.⁹⁹ Even without using Section 220, plaintiffs may benefit from the reports

⁹⁶ *E.g.*, *Scattered Corp. v. Chicago Stock Exchange, Inc.*, 701 A.2d 70, 79 (Del., 1997) (denying plaintiffs’ request for discovery after they had “inexplicably” foregone a Section 220 search for relevant books and records); *Beam v. Martha Stewart Living Omnimedia, Inc.*, 833 A.2d 961, 982-83 (2003) (discussing the utility of a books and records search, citing various cases where Delaware courts urged plaintiffs to engage in such investigations, and noting that plaintiffs’ failure to do so was generated by a “‘first to file’ custom seemingly permitting the winner of the race to be named lead counsel”) (quoting *Rales v. Blasband*, 634 A.2d 927, 935 n.10 (Del. 1993)).

⁹⁷ The Sarbanes Oxley Act of 2002, *codified at* 15 U.S.C. §10A(4)(A).

⁹⁸ See Sarbanes Oxley §307; Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. §205.3(b) (2005) (obligating corporate attorneys to report “material violations” to the corporation’s officers and directors); 17 C.F.R. §205.2(i) (defining “material violation” as a “material violation of an applicable...federal or state securities law, a material breach of fiduciary duty...under...federal or state law, or a similar material violation of any...federal or state law.”).

⁹⁹ *Saito v. McKesson HBOC, Inc.*, No. Civ.A. 18553, 2002 WL 31657622, at *12-13 (Del. Ch. Nov. 13, 2002). The reasoning in *Saito* was based on *Deutsch v. Cogan*, where the court limited the ability of corporate officers accused of injuring the corporation to claim that their communications with the corporation’s attorneys were privileged. 580 A.2d 100, 106 (Del. Ch. 1990) (“[P]rotection of [shareholder] interests as well as those of the corporation and of the public require that the availability of the privilege be subject to the right of the stockholders to show cause why it should not be invoked in the particular instance.”) (quoting *Garner v. Wolfenbarger*, 430 F.2d 1093, 1103-04 (5th Cir. 1970)); see also William Simon, Speech to the Fourth Annual Rabbi Seymour Siegel Memorial Lecture in

of corporate attorneys, who in some circumstances are now empowered by the regulations enacted pursuant to Sarbanes-Oxley to communicate corporate misconduct to the S.E.C.¹⁰⁰ Of course, plaintiffs are also free to investigate other “tools at hand,” such as public filings and facts gathered from the media.¹⁰¹

Much has been written about the extent to which Sarbanes Oxley and related reforms have preempted substantive state corporate law.¹⁰² In truth, the federal government will do far more than change the law; in many cases it will change the facts, or at least change the facts that can be pleaded. By creating reams of information from which plaintiffs may draw, it has potentially transformed the shape of the litigation playing field in favor of plaintiffs.

C. Good Faith at the Motion to Dismiss Stage

Armed with information gathered with “the tools at hand,”¹⁰³ a plaintiff’s task at the motion to dismiss stage is somewhat simplified by the liberal pleading requirements of Del. R. Civ. Proc. 12(b)(6).¹⁰⁴ Although judges may not consider conclusory allegations, “plaintiffs are entitled to all reasonable factual inferences that logically flow from the particularized facts alleged.”¹⁰⁵

When a cause of action against directors who consciously disregard their responsibilities is applied to this most basic rule of civil procedure, the result is the effective elimination of

Ethics, *The Crisis of Professions in the Post-Enron Era*, at Duke University School of Law (Mar. 3, 2005) (opining that the “corporate attorney-client privilege is vanishing.”), recording available in RealVideo format at <http://realserver.law.duke.edu/ramgen/spring05/lawschool/03032005.rm>.

¹⁰⁰ 17 C.F.R. §205.3(d)(2).

¹⁰¹ *Brehm v. Eisner*, 746 A.2d 244, 249 (Del. 2000) (quoting *Rales v. Blasband*, 634 A.2d 927, 935 n.10 (1993)).

¹⁰² For a thorough discussion of new federal intrusions in what was once state corporate law, see generally Johnson & Sides, *supra* note 21; Bainbridge, *supra* note 21; see also *New Federalism*, *supra* note 23, at 953; Roe, *supra* note 14, at 632-34.

¹⁰³ *Brehm*, 746 A.2d. at 266.

¹⁰⁴ The Delaware rules governing motions to dismiss are similar to Rule 12(b)(6) of the Federal Rules of Civil Procedure. See Del. R. Civil Proc. 12(b)(6) (2001); Del. Super. Ct. R. 12(b)(6) (2001).

¹⁰⁵ *Brehm*, 746 A.2d at 255; see also *Beam v. Martha Stewart Living Omnimedia, Inc.*, 833 A.2d 961, 970 (Del. Ch. 2003) (“The Court will not dismiss under Rule 12(b)(6) any claim unless it appears to a reasonable certainty that the plaintiff cannot prevail on any set of facts which might be proven to support the allegations....”).

Section 102(b)(7) as viable means of keeping careless directors out of the courtroom.¹⁰⁶ Even when a corporate charter does not provide for exculpation, a claim for monetary damages based on breaches of the duty of care will be dismissed unless the complaint alleges that the defendants acted with gross negligence in observing their duties.¹⁰⁷ But just about any act or omission that can be performed negligently can also be done on purpose. If the act occurred in a *grossly* negligent manner, then its very “wantonness”¹⁰⁸ raises a “factual inference”¹⁰⁹ that the act was egregious, willful, badly-motivated, or perhaps “deliberately indifferent.”¹¹⁰ Thus, by alleging facts that amount to gross negligence, plaintiffs will generally earn the right to use discovery to attempt to dig up evidence of disloyalty or bad faith.¹¹¹

Given its procedural posture, *Disney II* can be viewed as both less and more than what it initially seems. On the one hand, the opinion can be seen as nothing more than a denial of a motion to dismiss that allows the parties to proceed with discovery.¹¹² On the other hand, few people who have paid corporate attorneys’ fees, who have endured discovery, or who have stood trial for several times their net worth would ever be heard uttering the phrase “nothing more than a denial of a motion to dismiss.” Nor should fiduciaries have much confidence in being able to

¹⁰⁶ Cf. *Critique of Van Gorkom*, *supra* note 17, at 462 (doubting the continued effectiveness of Section 102(b)(7)).

¹⁰⁷ See *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985) (applying a standard of gross negligence to determine whether directors violated their duty of care).

¹⁰⁸ See BLACK’S LAW DICTIONARY (4th ed. 1968), at 1185 (defining “gross negligence” as “such a gross want of care and regard for the rights of others as to justify the presumption of willfulness and wantonness”).

¹⁰⁹ See *Brehm*, 746 A.2d at 255.

¹¹⁰ See *Disney II*, 825 A.2d 275, 289 (Del. Ch. 2003); see also *Emerald Partners v. Berlin*, 787 A.2d 85, 92 (Del. 2001) (holding that director exculpation from duty of care violations should not result in dismissal of a complaint unless the facts alleged point exclusively to violations of the duty of care).

¹¹¹ The one circumstance where an exculpation provision may lead to the dismissal of complaint is when the complaint alleges conduct traditionally viewed as simple negligence but which nevertheless invokes the duty of care under *Van Gorkom*. See, e.g., *Apple Computer, Inc. v. Exponential Tech., Inc.*, No. 16315, 1999 WL 39547, at *7 (Del. Ch. Jan. 21, 1999); see also *Critique of Van Gorkom*, *supra* note 17, at 458 (stating that *Van Gorkom* purported “to apply the gross negligence standard of review” but “in reality...applied an ordinary negligence standard”). But since *Brehm* has now adopted a more rigorous standard of gross negligence, Delaware courts will be able to dismiss such suits for failure to allege any fiduciary duty violation, rather than for failing to allege conduct incapable of exculpation under Section 102(b)(7). See Discussion, notes 59-60 and accompanying text.

¹¹² See *Disney II*, 825 A.2d at 291.

resolve their suits at summary judgment. Since *Disney II* sets up a scienter-based standard,¹¹³ Delaware judges may hesitate to decide cases without hearing the testimony of those whose state of mind is being questioned. In sum, Section 102(b)(7) may sometimes protect directors from liability, but it will almost never shield them from trial.

D. Good Faith at Trial

Once a case goes to trial, the plaintiffs must strip defendants of the protections of the business judgment rule by proving that the defendants either committed waste or breached their fiduciary duties.¹¹⁴ That is, the plaintiffs must prove by a preponderance of the evidence that the director defendant acted disloyally, in bad faith, or without the requisite level of care. In the *Disney* trial, the court found little worthy of praise in the defendants' conduct, but ultimately held for the defendants because the plaintiffs had failed to prove a single breach of fiduciary duty.¹¹⁵

On the other hand, if a plaintiff proves that a breach of fiduciary duty occurred, then the burden switches to the defendant, who must prove that the challenged transaction was entirely fair to the corporation.¹¹⁶ To establish entire fairness, the defendant must first prove that the transaction was priced fairly for the corporation.¹¹⁷ In the context of a merger, courts normally decide the issue of fair price by appraising the target company with the help of expert

¹¹³ Official Comm. of Unsecured Creditors of Integrated Health South Servs., Inc. v. Elkins, No. Civ.A. 20228-NC, 2004 WL 1949290, at *17 n.92 (Del. Ch. Aug. 24, 2004).

¹¹⁴ See *Disney III*, C.A. No. 15452, 2005 WL 2056651, at *36 (Del. Ch. Aug. 9, 2005). However, if the claim concerns a self-interested transaction, then the defendant will have the burden of proving entire fairness *ab initio*. *Emerald Partners*, 787 A.2d at 98-99.

¹¹⁵ *Disney III*, 2005 WL 2056651 at *1.

¹¹⁶ *Id.* at *37; see also *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1163 (Del. 1995) (“[A]n initial judicial determination that a given breach of a board's fiduciary duties has rebutted the presumption of the business judgment rule does not preclude a subsequent judicial determination that the board action was entirely fair, and is, therefore, not outcome-determinative *per se*.”) (emphasis in original). For an example of defendants meeting the burden to show entire fairness, see *Emerald Partners v. Berlin*, No. Civ.A. 9700 (Apr. 28, 2003), 2003 WL 21003437, at *38 [hereinafter *Emerald Partners III*].

¹¹⁷ *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983). The defendants need only prove that the price was fair at the time the transaction was approved; they need not prove that the transaction ultimately turned out positively for the corporation. See *Emerald Partners*, 2003 WL 21003437, at *38 (holding that the merger was fair to the shareholders on the date it was consummated).

witnesses.¹¹⁸ In such circumstances, courts must examine “assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company’s stock.”¹¹⁹ Whether an employee’s compensation can be appropriately appraised along the same lines is a question that Delaware Supreme Court has yet to answer.

The second prong of the entire fairness test requires the defendant to prove that the transaction was the product of fair dealing.¹²⁰ This inquiry “embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of directors...were obtained.”¹²¹

Finally, defendants who benefit from an exculpatory provision may argue that even if the transaction were unfair, it was merely the product of a lapse of care and therefore cannot give rise to director liability.¹²² An exculpation provision permitted by Section 102(b)(7) acts as an affirmative defense.¹²³ Thus, if a defendant's breach of fiduciary duty is found to have caused the corporation to engage in an unfair transaction, then the burden of proof shifts to the defendant, who must prove by a preponderance of the evidence that the breach was "exclusively attributable to a violation of the duty of care.”¹²⁴ Directors who fail to surmount this burden will be personally liable for damages.

¹¹⁸ In such circumstances a fiduciary duty claim will often be consolidated with a shareholder appraisal under DEL. CODE ANN., tit. 8, Section 262 (2001). *See, e.g., In re Emerging Communications, Inc. S’Holders Litig.*, No. Civ.A. 16415, 2004 WL 1305745 (Del. Ch. June 4, 2004).

¹¹⁹ *Weinberger*, 457 A.2d at 711.

¹²⁰ *Id.*

¹²¹ *Id.*

¹²² *See, e.g., Emerging Communications*, 2004 WL 1305745, at *38; *see also* Barney Gimbel, *Why We’ll Miss the Disney Trial*, FORTUNE, Dec. 27, 2004, at 34 (“Incompetence pays.”).

¹²³ *Emerald Partners v. Berlin*, 726 A.2d 1215, 1223 (Del. 1999).

¹²⁴ *Emerging Communications*, 2004 WL 1305745, at *40 (quoting *Emerald Partners v. Berlin*, 787 A.2d 85, 98 (Del. 2001)). Delaware differs substantially from other jurisdictions in assigning the burden of proof in fiduciary duty actions. *See, e.g., OH. REV’D CODE ANN. §1701.59(D)* (1999) (“A director shall be liable in damages for any action that the director takes or fails to take as a director *only if it is proved by clear and convincing evidence* in a court of competent jurisdiction that the director's action or failure to act involved an act or omission undertaken with deliberate intent to cause injury to the corporation or undertaken with reckless disregard for the best interests of the corporation.”) (emphasis added).

One question left unresolved by *Emerald Partners* is which side bears the burden of production when directors defend themselves on the ground that their actions were exclusively attributable to a lack of due care. One possibility is that defendants will be forced to produce evidence of their their loyalty and good faith once they are found to have breached any fiduciary duty. Alternatively, plaintiffs might need to prove a *prima facie* case of disloyalty or bad faith before the defendants can be obligated to prove that the breach of fiduciary duty was exclusively a product of insufficient care. Usually the party bearing the burden of persuasion will also bear the burden of producing evidence in her favor.¹²⁵ Therefore, defendants generally bear the burden of producing evidence to support an affirmative defense.¹²⁶

However, in *Emerging Communications* Justice Jacobs placed the burden of production on the plaintiffs.¹²⁷ The court found that seven directors had breached their fiduciary duties to minority shareholders by approving a grossly unfair telecommunications merger in which the target corporation stood on opposite sides of the table from its Chairman and CEO, Jeffrey J. Prosser.¹²⁸ Nevertheless, the court found that four of them were shielded from liability by the company's exculpation provision because the plaintiffs had failed to present a *prima facie* case of bad faith or disloyalty that th[o]se directors would be called upon to negate or disprove."¹²⁹ In other words, a breach of fiduciary duty will not automatically create a presumption of bad faith or disloyalty that the defendant will need to disprove. Rather, the court will presume that the

¹²⁵ Christopher B. Mueller and Laird C. Kirkpatrick, *FEDERAL EVIDENCE* §65 (2d ed. 2004).

¹²⁶ *See id.*

¹²⁷ *Emerging Communications*, 2004 WL 1305745, at *42. The Justice was sitting on the Court of Chancery by designation. *Id.* at n.*. The bifurcation of evidentiary burdens in *Emerging Communications* is indicative of Justice Jacobs' clearly-stated opposition to treating a Section 102(b)(7) provision as an affirmative defense. *See Critique of Van Gorkom*, *supra* note 17 at 463 -64 (describing *Emerald Partners I* as an "unfortunate" development that "dysfunctionally undercuts the purpose of section 102(b)(7)" and "perpetuates costly litigation without creating any countervailing social utility").

¹²⁸ *Emerging Communications*, 2004 WL 1305745, at *1, *41-43. In a consolidated appraisal action arising from the same transaction, the court valued the company at nearly four times the price paid to the cashed out shareholders. *Id.* at *43.

¹²⁹ *Id.* at *42.

breach was exclusively the product of a lack of due care until the plaintiffs produce evidence to the contrary.¹³⁰

Plaintiffs need not present direct evidence of the defendant's intent in order to meet the burden of production.¹³¹ Instead, a defendant's expertise, actions, and general situation can serve as circumstantial evidence that the defendant either knowingly harmed the corporation or "consciously and intentionally disregarded [his or her] responsibilities."¹³² But while plaintiffs can survive a motion to dismiss by pleading facts that raise an inference of bad faith,¹³³ at trial the plaintiffs must prove that the corporate injury was caused by something more than gross negligence. To determine what circumstantial evidence will be sufficient to meet this burden, courts will need to make context-specific inquiries into the facts of each case as they relate to each director.

For example, in *Emerging Communications* the court had little difficulty finding Prosser liable after concluding that, in order to "to force out ECM's minority at an unfair price," he had hidden the existence of internal financial projections that drastically increased ECM's value.¹³⁴ But defendant Salvatore Muoio presented a more difficult case, since he had no knowledge of the hidden projections and was not even a member ECM's merger committee.¹³⁵ Nevertheless, the court held Muoio liable because his extensive experience in finance and telecommunications put him in a position to know, or to at least have "strong reasons to believe," that minority

¹³⁰ See *id.*

¹³¹ See *id.* at *40 (finding a director liable while admitting that no court could infallibly divine the operations of his mind).

¹³² *Disney II*, 825 A.2d at 289 (italics removed from original); see also *Emerging Communications*, 2004 WL 1305745, at *42-43; Official Comm. of Unsecured Creditors of Integrated Health South Servs., Inc. v. Elkins, No. Civ.A. 20228-NC, 2004 WL 1949290, at *17 n.92 (Del. Ch. Aug. 24, 2004) ("Rarely, if ever, will a plaintiff have direct evidence of a board's intent. Yet the *Disney* standard is scienter-based. Thus, the Court will generally be required to look to the Board's actions as circumstantial evidence of state of mind.").

¹³³ See Discussion, *supra* notes 103-113 and accompanying text.

¹³⁴ *Emerging Communications*, 2004 WL 1305745, at *42.

¹³⁵ *Id.* at *6-7.

shareholders were being treated unfairly.”¹³⁶ In other words, a person with Muoio’s abilities would probably not have voted for the merger unless he had been motivated by overt disloyalty or by a conscious and intentional disregard of his fiduciary duties.¹³⁷ On the other hand, the court did not find defendant John G. Vondras to have been in a similar “position to know,” even though Vondras was a professional engineer, a member of the merger committee, and a telecommunications executive with over twenty-five years of industry experience.¹³⁸

Emerging Communications illustrates the fact-dependant nature of inquiries into a director's loyalty and good faith. Delaware judges will have substantial flexibility, as they always have, to apply principles of good faith and loyalty to specific situations as warranted by the circumstances.¹³⁹

As of today, the Delaware Supreme Court has not yet reviewed Justice Jacobs’ determination that the burden of production falls on the plaintiff when a defendant relies on an exculpatory provision as a defense under Section 102(b)(7). If the court does not adopt the holding of *Emerging Communications*, then grossly negligent directors will be forced to produce evidence proving that they were *not* unfaithful or disloyal. If so, then corporate directors accused of fiduciary duty violations will find themselves in the uncomfortable position of claiming that they may have been fools, but were neither thieves, nor subversives, nor ostriches

¹³⁶ *Id.* at *39. The holding here can be seen as a mirror-image of Judge Learned Hand’s often-cited refusal to hold an inexperienced director liable for his lack of expertise. *See Barnes v. Andrews*, 298 F. 614, 618 (S.D.N.Y. 1924) (“True, he was not very well-suited by experience for the job he had undertaken, but I cannot hold him on that account. After all, it is the same corporation that chose him which now seeks to charge him.”). In contrast, the *Emerging Communications* shareholders elected an expert to serve on the board, and therefore had a right to expect that his expertise would be employed for their benefit. *See Emerging Communications*, 2004 WL 1305745, at *39.

¹³⁷ *Id.* at *40 (quoting *Disney II*, 825 A.2d at 289).

¹³⁸ *Id.* at *3, *42-43.

¹³⁹ The fact-specific nature of this inquiry is typical of Delaware fiduciary law, which has long-relied on “principles-based” decision-making. *New Federalism*, *supra* note 23, at 979 (“Delaware law has resisted...the recitation (by statute or case law) of a detailed set of particular measures that boards must take, or of certain transactions that boards must avoid, if they are to act equitably and lawfully.”); *Apple Computer, Inc. v. Exponential Tech., Inc.*, No. 16315, 1999 WL 39547, at *7 n.31 (Del. Ch. Jan. 31, 1999) (“This Court eschews inflexible rules that cannot discriminate good faith acts from disloyal conduct.”); *Kamar*, *supra* note 73, at 891 (“American corporate law is not an exact science.”).

who intentionally kept their heads in the sand.¹⁴⁰ Fact-finders are not likely to find such claims very credible, at least where Fortune 500 companies are concerned, because people usually do not get elected to the boards of large corporations by handling business affairs in a grossly negligent manner.¹⁴¹ But such defenses are not unheard of. For example, in order to defend himself against a federal prosecution for criminal fraud, former WorldCom CEO Bernard Ebbers testified that “he was ignorant about accounting,” and had done “poorly in college, where his ‘marks weren’t too good.’”¹⁴² In the end the jury did not find Ebbers’ self-professed naïveté to be very convincing.¹⁴³

On the other hand, if the Supreme Court decides to place the burden of production on plaintiffs, the burden will be far from impossible to meet.¹⁴⁴ Plaintiffs will generally prevail if they can produce evidence that directors had plotted against the corporation’s interests or averted their eyes while others carried out a such a scheme.¹⁴⁵ It would also be difficult to imagine a case where plaintiffs could not prevail after presenting evidence that defendants had either lied or hidden material information from shareholders.¹⁴⁶

Furthermore, evidence of a director’s experience, abilities, or expertise may be used to rebut any claims of ignorance that the director may raise in his defense.¹⁴⁷ Where a breach of fiduciary duty involves an incorrect valuation, a failure to disclose financial information, or other

¹⁴⁰ Such arguments will prove to be particularly weak defenses for CEO’s who had previously garnered gigantic compensation packages by selling themselves as geniuses to investors. See Kurt Eichenwald, *When the Top Seat is the Hot Seat*, N.Y. TIMES, March 16, 2005, at C1.

¹⁴¹ Cf. *Emerging Communications*, 2004 WL 1305745, at *40 (finding that a director acted out of disloyalty rather than lack of care because he was an expert in both telecommunications and finance and therefore probably knew that the disputed merger was harmful to minority shareholders).

¹⁴² Ken Belson, *Ebbers Mounts an “I Never Knew” Defense*, N.Y. TIMES, March 1, 2005, at C1.

¹⁴³ Ken Belson, *Ex-Chief of WorldCom is Found Guilty in \$11 Billion Fraud*, N.Y. TIMES, March 16, 2005, at A1 (“Mr. Ebbers’ testimony that he did not know about the fraud, according to one juror, was unconvincing.”).

¹⁴⁴ See *Emerging Communications*, 2004 WL 1305745, at *39-40 (finding three directors liable for breaching their duties of loyalty and/or good faith).

¹⁴⁵ See *id.* at *39-41.

¹⁴⁶ See *id.* at *37 (noting that shareholders were materially misled by the corporation’s failure to disclose its most recent financial projections before the merger was approved).

¹⁴⁷ See, e.g., *id.* at *40.

accounting irregularities, federal law will make such rebuttals more credible by mandating the inclusion of financial experts on key board committees. For example, under Sarbanes-Oxley, the audit committee of the board of every publicly-trade company is required have at least one financial expert.¹⁴⁸ Directors who qualify as financial experts under federal law will be hard-pressed to convince a Delaware court that their breach of fiduciary duty can best be explained as the product of their ignorance or gross negligence rather than bad faith or disloyalty.¹⁴⁹

V. The Fallout From a More Vigorous Good Faith Standard.

Recent developments in state corporate law have combined with federal regulation under Sarbanes-Oxley to create a more hospitable environment for shareholder plaintiffs who seek to make corporate fiduciaries pay for breaches of their duties. Such a state of affairs will inevitable result in more claims being filed, many of which will survive a motion to dismiss.¹⁵⁰ As plaintiffs' attorneys make use of new legal developments to rack up their victories, the settlement

¹⁴⁸ See, e.g., Sarbanes Oxley Act of 2002 §407, 15 U.S.C. §7265; see also Instruction to paragraph (h)(1) of Item 401 of Regulation S-K, (codified at 17 C.F.R. §229.401 (2004)) (allowing issuers to disclose the names of more than one financial expert).

¹⁴⁹ Of course, Delaware courts are not required to adopt a federal definition of expertise. But they will be eager to harmonize their standards with evolving federal norms in order "to avoid whipsawing corporate directors with incompatible dictates." *New Federalism*, *supra* note 23, at 987. But see Regulation S-K Item 401(h)(4)(ii) (codified at 17 C.F.R. §229.401(h)(4)(ii)) ("The designation or identification of a person as an audit committee financial expert pursuant to this Item 401 does not impose on such person any duties, obligations or liability that are greater than the duties, obligations and liability imposed on such person as a member of the audit committee and board of directors in the absence of such designation or identification.").

Also, the fact-bound nature of Delaware fiduciary duty law counsels against making any universally-applicable guidelines. For example, if a breach of fiduciary duty involved a very specialized form of financial trickery, then perhaps directors who generally qualify as financial experts will be able to convince a court that their errors were caused by a combination of gross negligence and lack of expertise in that particular specialty, rather than by bad faith or disloyalty.

¹⁵⁰ The Delaware Court of Chancery will be called upon to separate the wheat from the chaff. In fact, in a recent panel discussion on Managing the Liability Exposure of Directors, Vice Chancellor Strine expressed his dismay at the tendency of some plaintiffs' attorneys to create a claim for bad faith out of just about any losing investment. Remarks at the Directors' Education Institute, Duke University, Durham, N.C. (Mar. 18, 2005).

value of both new and long-running cases will increase as corporate defendants scramble to avoid the prospect of trial and damages.¹⁵¹

Nevertheless, the growth in the number of settlements might be less than is generally expected, thanks to a few quirks of the laws of Delaware. For example, under Delaware law the Court of Chancery must approve any settlements in shareholder class actions or derivative claims, a process which “involves a close judicial inspection of the proposed settlement on its merits.”¹⁵² This process is somewhat handicapped by the fact that the court cannot rely on an adversarial process to weed out truthful information.¹⁵³ However, the Delaware courts can be assisted in this process by active and engaged institutional investors, who can play a productive role policing both defendant directors and plaintiffs’ attorneys.¹⁵⁴

In addition, negotiations between shareholders and directors will be complicated by the directors’ liability insurance provider, who usually will not be required to pay a settlement that it does not consent to.¹⁵⁵ Most director and officer insurance (“D&O”) policies exclude coverage for wrongful conduct such as “intentionally dishonest acts or omissions, fraudulent acts or omissions, criminal acts or omissions, willful violations of any statute, rule, or law, illegal profit, or illegal remuneration.”¹⁵⁶ However, if the D&O provider consents to a settlement before the court decides the merits of a case, then the insurer will be required to pay the full policy

¹⁵¹ See Harold S. Bloomenthal, SETTLEMENTS AND THE PSLRA SEC. LAW HANDBOOK §30:21 (updated December 2004) (“It cannot be gainsaid that a claim that survives a motion to dismiss has an enhanced settlement value....”).

¹⁵² Kamar, *supra* note 73, at 898; *see also* Del. Ch. Ct. R. 23, 23.1 (2005).

¹⁵³ *Cf.* Angiolillo, *supra* note 77, at 305 (observing, in the context of federal class actions, that “it is no secret that in seeking court approval of their settlement proposal, plaintiffs’, attorneys’, and defendants’ interests coalesce and mutual interest may result in mutual indulgence.”) (quoting Kaplan v. Rand, 192 F.3d 60, 67 (2d Cir. 1999)) (internal quotation marks omitted).

¹⁵⁴ See Weiss *supra* note 92, at 1801 (describing how the involvement of objectors can alter the probability of a settlement being approved).

¹⁵⁵ Christopher W. Martin, *Director and Officer Insurance*, 41 HOUSTON LAW. 38, 42 (2004).

¹⁵⁶ *Id.* (capitalization and bullet-points removed).

amount.¹⁵⁷ Thus, the interests of all parties to the shareholder litigation may converge or diverge in unpredictable ways.

Plaintiffs, for example, will need to plead facts that indicate that defendants acted disloyally, in bad faith, or in some other manner that precludes exculpation under Section 102(b)(7) in order to survive a motion to dismiss.¹⁵⁸ However, once a motion to dismiss is denied, the shareholders may hesitate to take the case to trial, lest the court find that the alleged conduct was excludable under the defendant's insurance policy. Such a finding could leave the defendants judgment-proof. On the other hand, plaintiffs who face particularly wealthy defendants may not be very concerned about the scope of the defendant's insurance coverage.¹⁵⁹ Furthermore, plaintiffs may insist that defendants pay some damages out of their own pockets in order to deter future misconduct. The shareholders may also seek injunctive relief, such as reform of the firm's corporate governance.¹⁶⁰

Nor will defendants always have the same interests as their D&O providers. On the day a suit is filed, both directors and insurers will want to see the complaint dismissed, since dismissal on the pleadings would eliminate the risk of liability with minimal litigation costs. But as pointed out earlier, defendants cannot expect all complaints to be dismissed, especially in light of recent state and federal developments in corporate law.¹⁶¹ Once a motion to dismiss is denied, the interests of defendant and insurer may diverge.

¹⁵⁷ *Id.*

¹⁵⁸ See Discussion, *supra*, Part IV.C.

¹⁵⁹ For the same reason, plaintiffs should be less eager to settle compensation suits, because the defendant will presumably be able to pay an adverse judgment with the allegedly improper compensation. See, *Disney II*, 825 A.2d 275, 279 (Del. Ch. 2003) (alleging that defendant Michael Ovitz was paid over \$140 million); *Official Committee of Unsecured Creditors of Integrated Health Svcs., Inc. v. Elkins*, No. Civ.A 20228-NC (Del. Ch., Aug. 24, 2004), 2004 WL 1949290, at *1.

¹⁶⁰ See Gibeaut, *supra* note 79, at 40-41. Attorney Patrick S. McGurn of Institutional Shareholder Services labels such demands "good governance at gunpoint." *Id.*

¹⁶¹ See Discussion, *supra* Part IV.

Defendants will usually be eager to settle for any amount lower than the value of the insurance policy. Insurers, on the other hand, will be more willing to go to trial if they perceive the proposed settlement to be more costly than litigation. Thus, if the insurer suspects that its customer engaged in conduct that is excluded under the policy, it may prefer to litigate and lose on the merits so as to relieve itself of liability for damages. Now that Delaware holds directors liable for breaches of the duty of good faith,¹⁶² D&O providers may modify their policies to explicitly deny coverage for bad faith conduct. Insurers who do not already exclude bad faith might argue that a judicial finding of bad faith triggers exclusions for acts or omissions that are “[i]ntentionally dishonest” or that willfully violate a “statute, rule or law.”¹⁶³

On the other hand, the insurer might agree to a settlement if it decides that legal or market forces compel it to accept a “reasonable” offer.¹⁶⁴ Finally, the complications outlined above will multiply whenever the interests of officers and directors diverge from the interests of the corporation with whom they might share D&O coverage.¹⁶⁵

Whether a particular case settles, and for how much, will depend on the interplay between the interests noted above,¹⁶⁶ which game theorists might see as a dynamic game with imperfect information.¹⁶⁷ Plaintiffs’ attorneys would probably call the situation a gamble, while defense lawyers might prefer the term “billing opportunity.” To the parties themselves, it is a mess. The upshot of these barriers to settlement will be that many fiduciary duty litigants will be unable to avoid trial.

¹⁶² See *Disney II*, 825 A.2d 275, 278 (Del. Ch. 2003).

¹⁶³ See Martin, *supra* note 155, at 42.

¹⁶⁴ See *id.* (recommending that directors decline to purchase insurance policies that permit the insurer to unreasonably withhold consent to a settlement).

¹⁶⁵ See *id.* at 44-45.

¹⁶⁶ Of course, the underlying facts of the case will also be relevant.

¹⁶⁷ Cf. Ian Ayres, *Playing Games with the Law*, 42 STAN. L. REV. 1291, 1294-97 (describing how civil litigation settlement strategies can be modeled using game theory) reviewing Eric Rasmusen, *GAMES AND INFORMATION: AN INTRODUCTION TO GAME THEORY* (Oxford: Basil Blackwell, 1989).

But although the short-term result of recent corporate law developments will be more litigation, over time the perceived willingness of Delaware courts to find directors accountable may motivate them to improve the governance of their corporations in the hope of reducing their exposure to liability.¹⁶⁸ For instance, directors could adopt corporate “best practice” policies that ensure that key decisions are made carefully, deliberately, and objectively.¹⁶⁹ They also can be expected to better document their decision-making processes in order to deny plaintiffs’ attorneys the “particularized facts necessary to” remove the protections of the business judgment rule.¹⁷⁰ For example, directors who hope to avoid the fate of the defendants in *Disney II* might seek to create better records of the processes they use to approve executive compensation packages.¹⁷¹ It remains to be seen if such documentation will be effective in dismissing claims that seek to hold directors responsible for allegedly bad faith actions or omissions.

¹⁶⁸ Any improvements in corporate governance will also be attributable to increased shareholder activism, *see* Levitt, *supra* note 70 at A16, and to federal and SRO regulations that have essentially codified what were once aspirational corporate governance norms. *See New Federalism*, *supra* note 23, at 957.

¹⁶⁹ Delaware judges have on multiple occasions encouraged directors to adopt “best practices” of corporate governance, although they generally mention that such practices are not required to fulfill one’s fiduciary duties to the corporation. *See, e.g.,* Veasey, *supra* note 24, at 1450, 1456-57 (quoting *Brehm v. Eisner*, 746 A.2d 244, 256 (Del. 2000)).

¹⁷⁰ *See Brehm*, 746 A.2d at 249.

¹⁷¹ *Cf.*, 825 A.2d 275, 278 (Del. Ch. 2003) (noting that the “complaint suggests that the Disney directors failed to exercise *any* business judgment and failed to make *any* good faith attempt to fulfill their fiduciary duties...” (emphasis in original)).

CONCLUSION

Recent developments in state and federal law have given an advantage to plaintiffs at nearly every stage of a fiduciary duty suit. The whistle-blower protection provisions of the Sarbanes-Oxley Act have forced corporations to create a paper trail of misdeeds that plaintiffs' attorneys can then access by way of a books and records search under Section 220.¹⁷² These records might then form the basis of a complaint that can survive a motion to dismiss by stating facts with particularity that give rise to an inference that the director defendants acted disloyally or in bad faith. In fact, most complaints that merely allege gross negligence will survive a motion to dismiss, because any deed or omission amounting to gross negligence will, by its very wantonness, raise an inference that the conduct was either intentional or reflected a conscious disregard for the corporation's welfare.

If the complaint survives a motion to dismiss and the case goes to trial, plaintiffs will then need to prove that the defendants breached a fiduciary duty. If they succeed, the defendants will have the burden of proving that the disputed transaction was entirely fair to the corporation.

Alternatively, the defense may seek to escape liability by convincing the court that the breach of fiduciary duty was entirely the result of a lack of due care. Delaware law is uncertain regarding which side has the burden of producing evidence at this point in the litigation. If the court imposes the burden of producing evidence of non-exculpable conduct on the plaintiffs, then defendants may succeed in convincing the court that plaintiffs failed to state a *prima facie* case of bad faith or disloyalty. However, if the burden of production remains on defendants, then the directors will face the daunting and unpleasant task of convincing a court that they may have

¹⁷² See *Beam v. Martha Stewart Omnimedia, Inc.* 833 A.2d 961, 982 n.67 (2003) (noting, according to counsel for the plaintiffs, that filing requests for books and records has become "a standard practice")

been grossly negligent, but were nevertheless motivated by only the purest desire to promote the interests of shareholders.

Some commentators have assured directors that the vast majority of them need not worry about personal liability for breaches of fiduciary duties.¹⁷³ These commentators are correct insofar as that relatively few directors will act with the requisite gross negligence that constitutes lack of due care. But directors are concerned about more than liability—they and their insurers prefer to stay out of the courtroom entirely. Given the weakness of Section 102(b)(7) as a means of winning a motion to dismiss, directors who act without due care should not expect to be able to avoid either settlement or trial.

Of course, the Delaware plaintiffs' bar is not blind to these developments, and can be expected to aggressively employ whatever new tools the law has provided. As a result, corporate boards should expect shareholder plaintiffs to increasingly win favorable settlements and judgments in fiduciary duty actions.

¹⁷³ E.g., Veasey, *supra* note 24, at 1458 (quoting Remarks of Vice Chancellor Strine, in Thomas A. Roberts, et. al., *Director Liability Warnings from Delaware*, BUS. & SEC. LITIGATOR, Feb. 2003, at 12); Jaclyn J. Janssen, Note, *In Re Walt Disney Company Derivative Litigation: Why Stockholders Should not Put too Much Faith in the Duty of Good Faith to Enhance Director Accountability*, 2004 WISC. L. REV. 1573 (2004).

APPENDIX

DEL. CODE. ANN., tit. 8, §102(b)(7) (2001):

(b) ...[T]he certificate of incorporation may...contain any or all of the following matters:

... (7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this paragraph to a director shall also be deemed to refer (x) to a member of the governing body of a corporation which is not authorized to issue capital stock, and (y) to such other person or persons, if any, who, pursuant to a provision of the certificate of incorporation in accordance with §141(a) of this title, exercise or perform any of the powers or duties otherwise conferred or imposed upon the board of directors by this title.